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IRS Attacks on Art Donations: Old Techniques, New Hurdles

by Hale E. Sheppard

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In this article, Sheppard examines the IRS's recent focus on artwork donation schemes and the hurdles that it might encounter in applying the economic substance doctrine.

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I. Introduction

If people have learned anything from the recent disputes over charitable donations of conservation easements, it is that the IRS has a playbook. It involves announcing far and wide that the main problem is excessive valuation, followed by attacks on essentially everything other than what the donation is worth. For instance, the IRS often raises at the outset a list of technical issues — meaning supposed flaws in the vast amount of documentation required of donations. Next, the IRS cites broader judicial theories, among them that the relevant transactions supposedly lack economic substance because the taxpayer was primarily concerned about tax deductions. Grounded in those two notions and perhaps others, the IRS regularly issues at the end of an audit a notice of deficiency — or the partnership equivalent — claiming that the taxpayer should get a tax deduction of $0, and steep penalties apply.

The IRS has already experienced problems using this strategy in the conservation easement context, and things might get harder for the IRS if it plods ahead in the same manner when it comes to art donations.

This article explains the general rules for donating artwork, the recent IRS announcement about promotions of improper donation schemes, and potential hurdles for the IRS if it insists on applying the economic substance doctrine, alleging that art donations are worth $0, or badgering recipients of donations.

II. Overview of Charitable Art Donations

Congress encourages taxpayers to make donations to charitable causes. Lest there be any doubt about that, one simply needs to consult section 170, which allows taxpayers to claim tax deductions for doing so.[1] Offering incentives for taxpayers to act charitably is one thing; figuring out the value of that benevolent behavior is another. Valuation is a perennial dispute.

The value of a charitable donation is the fair market value of the property at the time of the donation.[2] The term FMV ordinarily means the price on which a willing buyer and willing seller would agree if neither party were obligated to participate in the transaction and if both parties had reasonable knowledge of the relevant facts.[3] Perhaps the best evidence of the FMV of a specific item is the sales price of items with similar descriptions, conditions, sizes, etc. A major difficulty is identifying these so-called comparables. This can be especially challenging when a donation is an artistic work, which is unique by nature.[4]

The IRS takes the position that valuation of art depends heavily on educated opinions, and the weight given to those opinions depends on the

[1] Section 170.

[2] Section 170(a)(1); reg. section 1.170A-1(c)(1).

[3] Reg. section 1.170A-1(c)(1) and (2).

[4] IRS Publication 561, "Determining the Value of Donated Property" (2023).

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knowledge and competence of the experts, as well as the thoroughness with which the opinions are supported.[5] Regarding relevant data, the IRS indicates that, when it comes to artwork, a credible valuation includes the following:

- a complete description of the piece, including its size, subject matter, artist, and approximate date of creation;
- the cost, date, and manner of acquisition by the donor;
- a history of the piece, including proof of authenticity;
- a high-quality image of the piece; and
- the facts on which the appraisal was based, such as sales of similar works by the same artist, a record of exhibitions at which the art was displayed, the economic state of the art market at the time of the donation, and the professional standing of the artist.[6]

Cognizant of the challenges in valuing artwork, Congress and the IRS have created various mechanisms to streamline the process. For example, taxpayers looking to avoid potential squabbles with the IRS can solicit a statement of value before filing the relevant tax returns if the value of the item is presumed to exceed $50,000.[7] The IRS has also formed Art Appraisal Services — a team of specially trained appraisers who respond to requests for statements of value and support the IRS during audits, administrative appeals, and tax litigation.[8]

Finally, the Art Advisory Panel, established more than five decades ago, is a group of up to 25 experts who meet regularly, discuss items submitted to Art Appraisal Services for review, and provide opinions on value.[9] According to the IRS, the Art Advisory Panel is essential in "fostering voluntary compliance," its recommendations "play an important role in the IRS's efforts to cost-effectively address the potentially high abuse area of art valuation," and it supplies "information, advice, and insight into the world of art which cannot be obtained effectively from within the IRS."[10]

What the IRS thinks in terms of value and how it got there should be of no surprise. Indeed, if the IRS proposes a value that differs from what the taxpayer originally asserted, in some contexts the taxpayer has the right to demand a statement from the IRS revealing the basis for the valuation, all pertinent computations, and a copy of any appraisal made by or for the IRS.[11]

Claiming a tax deduction for an art donation can be complicated. Among other things, taxpayers must obtain a qualified appraisal from a qualified appraiser; demonstrate that the charity is a qualified organization; obtain a contemporaneous written acknowledgement of the donation; complete Form 8283, "Noncash Charitable Contributions"; and file a timely tax return with all necessary enclosures and disclosures.[12]

III. Warning About Art Donation Deductions

The IRS publicly announced in October 2023 that taxpayers should beware of "promotions involving exaggerated art donation deductions." It also inserted other loaded terms that it has used in other contexts, such as "inflated values" and "questionable appraisals."[13]

The IRS had to acknowledge that taxpayers are legally entitled to donate art and seek the corresponding tax deductions, but it cautioned that they should avoid "unscrupulous promoters" who make promises regarding art valuations that are "too good to be true." The IRS explained that some promoters (1) encourage high-income taxpayers to buy various types of art, usually at a "discounted" price; (2) provide

[5] *Id.* at 3.

[6] *Id.* at 10; *see also* IRS Publication 5497, "Photographic Requirements for Art, Antiques, Decorative Arts and Other Cultural Properties Reviewed by Art Appraisal Services and the Commissioner's Art Advisory Panel" (2021).

[7] Rev. Proc. 96-15, 1996-1 C.B. 627. The user fee for a statement of value covering up to three items is $7,500. Rev. Proc. 2023-1, 2023-1 IRB 1, appendix A.

[8] IRS Publication 561, *supra* note 4, at 11.

[9] IRS Publication 5392, "The Art Advisory Panel of the Commissioner of Internal Revenue" (rev. 2023).

[10] *Id.* at 3.

[11] These rules apply in the estate and gift tax context. Section 7517; reg. section 301.7517-1.

[12] *See* IRS Publication 1771, "Charitable Contributions — Substantiation and Disclosure Requirements"; IRS Publication 526, "Charitable Contributions," at 20 (2022); section 170(f)(8) and (11); reg. section 1.170A-13; Notice 2006-96, 2006-2 C.B. 902; reg. section 1.170A-16; reg. section 1.170A-17.

[13] IR-2023-185 (Oct. 5, 2023); Chandra Wallace, "Beauty Is in the Eye of Auditors for Art Donations, IRS Warns," *Tax Notes Federal*, Oct. 9, 2023, p. 333.

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additional services for which they can charge fees, such as shipping, storage, or appraisal of the art; (3) identify charities willing to accept the art; (4) instruct taxpayers to hold the art for more than one year before donating it, thereby making it long-term capital gain property; and (5) assist taxpayers in claiming tax deductions based on FMVs that far exceed the amount they paid for the art shortly before.[14]

The IRS then clarified that, thanks to recent legislation authorizing a larger enforcement budget, it plans to focus on high-income and high-wealth individuals. That gratuitous reminder to the very group of taxpayers who already pay the highest tax rates, not to mention nearly all the individual income taxes collected by the IRS, surely will elicit some contempt.

Piling on, the IRS admonished taxpayers that their reasonable reliance defenses to penalties might be questioned if they claim excessive values on artwork. The IRS announcement said that "taxpayers should remember [that] they are always responsible for the information reported on their tax returns." The IRS apparently did not want to omit anybody from possible challenges, so it added that charities need to be careful that they do not "enable these schemes." Finally, turning from talk to action, the IRS confirmed that it already has dozens of taxpayer examinations and promoter investigations underway.[15]

The IRS announcement also featured an overview of procedures for claiming tax deductions for donations of art. It explained that many donations require taxpayers to attach a completed Form 8283 and a qualified appraisal to their tax returns, obtain a timely contemporaneous written acknowledgement from the charity, maintain complete records about the donation, and more.[16]

The IRS then seemed to declare its readiness for valuation battles. Indeed, the announcement explained that the IRS has a team of "professionally trained appraisers" in its Art Appraisal Services, which is often augmented by the Art Advisory Panel.[17]

IV. Applying Old Theories to New Context?

Unless people have been living under the proverbial rock for the past half-decade, they know that the IRS has been aggressively challenging conservation easement donations during this period. However, even those aware of this enforcement might not recognize the overlapping issues. For example, they might not have realized yet that both easements and art involve charitable donations, both turn on the same tax provisions and regulations, both entail valuation components, and both are susceptible to many "technical" challenges by the IRS given the amount of paperwork required.

The IRS's playbook in attacking conservation easement donations has been fairly consistent. The IRS publicly decries "inflated values" and "questionable appraisals," but it often raises those issues last, if at all. The IRS first challenges technical issues, which deal exclusively with alleged shortcomings in one or more of the many documents that taxpayers must obtain to effectuate a donation. The IRS then cites various judicial theories, such as the transaction lacks economic substance solely because the taxpayer primarily cared about the tax deduction. Finally, at the end of the audit, the IRS inevitably asserts that the donated item is worth $0 and that the taxpayer should be hit with one of a cascade of alternative penalties.

Will the IRS follow that pattern when it comes to art donations? Doing so could be problematic for the IRS for several reasons.

A. Economic Substance and Charitable Donations

Section 7701(o) provides that when the economic substance doctrine applies, the transaction shall be treated as acceptable only if it meets two criteria. First, the transaction must change the taxpayer's economic position "in a meaningful way," apart from federal income tax effects. Second, the taxpayer must have a "substantial purpose" for engaging in the

[14] IR-2023-185.

[15] *Id.*

[16] *Id.*

[17] *Id.*

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transaction, apart from federal income tax effects.[18] Those are often called the *objective* profit potential test and the *subjective* non-federal-income-tax-purpose test.

A closer look reveals that the economic substance doctrine really has three parts, the first of which is foundational. Section 7701(o) begins with a critical limiting phrase indicating that the two-part test does not even apply unless the situation involves a "transaction to which the economic substance doctrine is relevant."[19] Legislative history, IRS rulings, and case law all support the notion that the economic substance doctrine generally is *not* relevant to transactions designed to qualify for congressional tax incentives.[20]

This article now turns to the role of the economic substance doctrine when it comes to tax deductions obtained in exchange for charitable donations. As explained, one does not make the fundamental decision about applicability of the economic substance doctrine by looking to section 7701(o), but rather by analyzing judicial precedent. Indeed, the law states that the determination of whether the economic substance doctrine pertains in the first place "shall be made in the same manner as if [section 7701(o)] had never been enacted."[21] Several courts have held that the economic substance doctrine normally is *not* relevant to charitable donations. A few are explored below.

1. *Skripak.*

The taxpayers in *Skripak* participated in a program whereby they executed a series of documents purporting to buy scholarly books for one-third of their retail price; held the books long enough to create long-term capital gain property; donated the books to small, rural public libraries; and claimed charitable donation deductions based on the *retail* price of the books, which was significantly higher than what the taxpayers had paid a short time earlier.[22]

The IRS audited, fully disallowed the claimed deductions, and imposed penalties. The IRS's primary theory was that the transaction was a sham that lacked economic substance, and thus should be ignored for tax purposes. The Tax Court rejected that argument:

> [The IRS] spent a great deal of time attempting to show that [the taxpayers] were completely inexperienced in every aspect of the book business and that [they] had virtually no chance of realizing an economic profit from their alleged acquisition and disposition of the reprint books. The record abundantly established that to be the case. *Although we accept the truth of these matters, we have made no express findings on these facts because they are not pertinent to our inquiry. The deduction for charitable contributions provided by Section 170 is a legislative subsidy for purely personal (as opposed to business) expenses of a taxpayer. Accordingly, doctrines such as business purpose and an objective of economic profit are of little, if any, significance in determining whether [the taxpayers] have made charitable gifts*. We think that the various documents [executed by the taxpayers and third parties] in fact comport with the economic substance and reality of these transactions, and we conclude that [the taxpayers] did in fact own and contributed the books to the various libraries.[23] [Emphasis added.]

The Tax Court expanded on this reasoning later in its opinion, criticizing the IRS for its singular and rigid focus:

> [The IRS's] seeming obsession with the mechanics of these transactions as shams appears to be caused by the admitted tax-avoidance motivation of [the taxpayers]. *However, as stated above, the deduction for charitable contributions was intended to provide a tax incentive for taxpayers to*

[18] Section 7701(o)(1) and (5)(D). The rules apply to a transaction "or series of transactions."

[19] Section 7701(o)(1).

[20] *See, e.g.*, H.R. Rep. No. 111-443, Vol. I, Division I, at 296 (Mar. 17, 2010); U.S. Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as Amended, in Combination With the Patient Protection and Affordable Care Act," JCX-19-10, at 152 n.344 (Mar. 21, 2010); LB&I-04-0711-015 (July 15, 2011); LB&I-04-0422-0014 (Apr. 22, 2022); and *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995).

[21] Section 7701(o)(5)(C).

[22] *Skripak v. Commissioner*, 84 T.C. 285 (1985).

[23] *Id.* at 314-315.

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support charities. Consequently, a taxpayer's desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution.[24] [Emphasis added.]

2. *Hunter*.

The taxpayers in *Hunter*[25] learned of a tax reduction program, promoted by Martin S. Ackerman, involving the purchase of "limited-edition prints" and the subsequent donation of that artwork to museums. Apparently, Ackerman, through one of his entities, purchased a large number of prints from a gallery for a low price because the gallery had owned them for a long time, failed to sell them to visitors, and now considered them excess inventory. Ackerman bought the prints for one-sixth of their retail price, sold them to the taxpayers for one-third of their retail price, and soon thereafter assisted the taxpayers in donating the prints and claiming charitable deductions for their full retail price.

In terms of procedure, Ackerman displayed on a table the prints for sale, placed those selected by the taxpayers in a separate drawer featuring their name, insured the prints, paid to have them packaged and shipped to museums after safeguarding them for over one year, and had the donations made in the name of the taxpayers.

The IRS audited the taxpayers and claimed that they should get a charitable deduction of $0 for a long list of reasons, among them that the transactions were shams and lacked economic substance. The IRS believed that the taxpayers had "merely purchased a tax deduction which promised a three-to-one write-off on their investment."[26]

The Tax Court swiftly rejected the IRS's contention, holding that the tax avoidance motive of the taxpayers in making the charitable donations did not preclude allowance of a deduction. The court alluded to what it said earlier, in *Skripak*, about Congress enacting section 170 to offer incentives to taxpayers to support charities and the IRS being unable to use a taxpayer's desire to reduce taxes as grounds for disallowing a deduction.[27]

3. *Weitz*.

The taxpayers in *Weitz*[28] participated in a program in which they pooled funds with several other investors, had their agent purchase medical equipment in their names at bankruptcy auctions for low prices from distressed sellers, stored the equipment for more than one year, donated the equipment to hospitals, and claimed charitable deductions based on the retail value of the equipment at the time of the donations. The taxpayers expected a four-to-one return on their investment — even after paying the agent's commission.

The IRS raised several arguments in an attempt to award the taxpayers a charitable deduction of $0, several of which involved economic substance in one fashion or another. The Tax Court, after dismissing other arguments advanced by the IRS, provided additional color regarding the inapplicability of the economic substance doctrine to situations involving charitable donations. It explained the following:

> Underlying each of [the IRS's] arguments is concern over the significant tax savings [the taxpayers] hoped to obtain as a result of their participation in the plan devised by [their agent and accountant]. [The taxpayers] and the other investors paid a relatively low price for the equipment which, at no cost or inconvenience to themselves, they stored for one year until they could donate it to [the hospital] and claim a charitable contribution deduction in an amount four times greater than their cash outlay. Nonetheless, [the taxpayers'] actions complied in every respect with statutory requirements. *As we recently noted in Skripak v. Commissioner, Section 170 allows a deduction from tax with respect to*

[24] *Id.* at 319.

[25] *Hunter v. Commissioner*, T.C. Memo. 1986-308.

[26] *Id.* The IRS raised additional arguments to support a full disallowance of the charitable donation deduction: (1) The taxpayers supposedly never owned the prints; (2) the taxpayers did not satisfy the long-term holding requirement; and (3) the activities of the taxpayers were substantially similar to those of commercial art dealers, so the prints constituted ordinary income property instead of capital gain property.

[27] *Hunter*, T.C. Memo. 1986-308.

[28] *Weitz v. Commissioner*, T.C. Memo. 1989-99.

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> *donations to charitable institutions even when the donation is carefully contrived to comply with the requirements of the applicable rules and regulations. [The taxpayers'] actions have been planned and executed to assure that their donation of medical equipment to [the hospital] would come within the definition of a deductible charitable contribution and all of the steps necessary to accomplish that goal have been effectuated. [The taxpayers] cannot be penalized for being careful.*[29] [Emphasis added.]

B. Zero Is Not a Good Starting Point

As with conservation easements, the IRS has taken the position in many art donation disputes that the item in question is worth $0 or, alternatively, no more than the taxpayer had paid to acquire it. Several courts have rebuffed those notions. Moreover, they have indicated frustration with the IRS and taxpayers, suggesting that extreme positions are unhelpful and that many valuation disputes should be resolved outside the court system. A few instances are set forth below.

1. *Rhoades.*

The taxpayers in *Rhoades*,[30] both airline pilots, bought two precious opals as an investment. They paid about $10,500 for one of the opals in 1979. As part of the process, they obtained three appraisals, all of which placed the value of the opal much higher than its acquisition price. That was because the taxpayers obtained the opals thanks to a forced sale: The sellers were getting divorced at the time. In 1981, just two years after buying the opals, the taxpayers donated one to the geology department of a university and claimed a charitable tax deduction of $70,000.

The IRS argued that the opal was worth exactly what the taxpayers previously paid for it (that is, $10,500), and not a dollar more. The valuation disagreement eventually led to Tax Court litigation. The IRS argued that "the purchase price . . . is the only reliable basis for determining the fair market value at the time of the contribution." The Tax Court balked at that idea. It found that the opal was worth $70,000 but that its value had to be reduced to $50,000 to account for the decrease occasioned by separating the pair of opals.

2. *Mast.*

The item donated in *Mast*[31] was a collection of stereoscopic glass plates, prints, and related materials — a noteworthy collection that was the largest ever assembled. The taxpayers donated the collection to a university and claimed a tax deduction of about $1.4 million based on an appraisal they had obtained. The IRS alleged that the unique collection was worth exactly $0.

Tax Court litigation ensued, of course. Before getting to the question of valuation, the Tax Court expressed its frustration at the IRS for taking such an extreme position. It insinuated that the normal standards should be mitigated because of the IRS's unreasonable starting point and lackluster proof at trial, as follows:

> Usually, [taxpayers] bear the burden of proving that the [IRS's] determination of the fair market value of property involved in the case is in error. In the particular circumstances of this case, however, we believe the weight to be given [to the IRS's] determination of value should be modified, and the burden of [the taxpayers] to show error in that determination should be mitigated to some extent. At trial, [the IRS] offered the testimony of an expert witness, who testified that the value of the collection was $450,000 to $500,000. [The IRS] offered no additional evidence to support either [its] zero value determined in the Notice of Deficiency or the value found by [its] only expert witness at trial. On the other hand, [the taxpayers] offered the testimony of several experts, one of whom had originally been retained by [the IRS], and all of whom testified the value was much greater. Under such circumstances, any presumption of correctness that might attach to [the IRS's] determination in the

[29] *Id.* (internal citation omitted).

[30] *Rhoades v. Commissioner*, T.C. Memo. 1988-279.

[31] *Mast v. Commissioner*, T.C. Memo. 1989-119.

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> Notice of Deficiency loses its conviction. By this we do not mean that the burden of proof shifts from [the taxpayers] to [the IRS], but only that [the taxpayer's] burden may be somewhat lightened.

After criticizing the IRS for suggesting an initial value of $0 and offering scarce support at trial, the Tax Court explained to the parties that it was not really equipped for the job:

> At the outset, we note that questions of fair market value are more properly resolved through settlement negotiation rather than litigation. In the absence of settlement, we are left to adjudicate the validity of [opinions by conflicting experts] who are convinced that both their conclusions and methods are correct. Unfortunately, since settlement was not forthcoming in this case, we are forced to make such a pronouncement.

The Tax Court concluded that the collection donated to charity was worth $1.25 million, which was about 90 percent of what the taxpayers originally claimed.

3. *Ferrari*.

One need not look hard to find another example of the Tax Court's exasperation at being required to place a value on art donations. The Tax Court said the following in *Ferrari*[32]:

> This case presents another instance whether this Court is called upon to value a relatively obscure collection of art objects on the basis of testimony by well-qualified individuals who unfortunately were able to arrive at a common valuation on only 2 out of 21 objects. This Court is called upon to exercise its judgment in an area totally foreign to the training and experience of a trial judge. This is a particularly apt example of a valuation controversy where arbitration by a third expert . . . would have been a far more satisfactory method of arriving at valuation for tax purposes.[33]

[32] *Ferrari v. Commissioner*, T.C. Memo. 1989-521.

[33] *Id.*

The annoyance of the Tax Court seemed to increase throughout its analysis, with it finally stating that "it is astounding that these parties would seek a court solution to such a fact situation rather than arbitration by an expert."[34]

V. Hassling Charitable Organizations, Too?

As explained, the IRS stated in its public release in October that charities must be careful not to enable schemes involving art donations.[35] The IRS seems to be threatening museums, universities, hospitals, libraries, and other recipients of charitable donations whose role usually is limited to receiving free things that they desperately need. Hmm, where else has the IRS recently taken a shotgun approach to enforcement, attacking taxpayers, alleged promoters, and even charities? If readers thought conservation easement disputes, they would be right.

After several courts held that the IRS broke the law when it unilaterally issued Notice 2017-10, 2017-4 IRB 544, labeling some conservation easement donations as "listed transactions," the IRS published proposed regulations in an effort to legalize matters.[36] The regulations contain potential changes affecting tax-exempt entities — such as land trusts — in their role as qualified organizations receiving easement donations.

The proposed regulations explain that section 4965 is intended to deter tax-exempt entities from facilitating prohibited tax shelter transactions.[37] If a transaction falls under the rubric of a tax shelter at the time the entity becomes a party to it, the entity must pay excise taxes and comply with reporting obligations.[38] An entity is considered a party to a transaction if it facilitates the transaction by reason of its tax-exempt, tax-indifferent, or tax-favored status.[39]

The proposed regulations state that, as of now, a qualified organization to which an easement is

[34] *Id.*

[35] IR-2-23-18.

[36] REG-106134-22 (Dec. 8, 2022); IRS Announcement 2022-28, 2022-52 IRB 659; Joseph DiSciullo, "Proposed Regs Require Reporting of Conservation Easement Deals," *Tax Notes Federal*, Dec. 12, 2022, p. 1565.

[37] Section 4965(e)(1)(A); REG-106134-22, at 12.

[38] Section 4965(a)(1); REG-106134-22, at 12.

[39] Reg. section 53.4965-4(a)(1); REG-106134-22, at 13.

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donated will *not* be treated as a party for excise tax purposes. They also indicate that a qualified organization will *not* be considered a participant for purposes of filing Form 8886, "Reportable Transaction Disclosure Statement."[40] That might change, though, because the proposed regulations suggest that eliminating those two exceptions could deter qualified organizations from enabling aggressive transactions.[41]

The proposed regulations further explain that promoters, appraisers, return preparers, and others who make any "tax statement" for specified transactions are material advisers. That unwanted status triggers the duty to file Form 8918, "Material Advisor Disclosure Statement," and maintain lists for IRS audits, and it creates exposure to serious penalties for noncompliance. Notice 2017-10 previously indicated that the IRS would *not* treat qualified organizations as material advisers, but the proposed regulations retract that exclusion.[42]

VI. Conclusion

Does the IRS loathe transactions with a tax component that are promoted in some manner? Does the IRS generally dislike engaging in cases centered on valuation because of their complexity, subjectivity, and unpredictability? Does the IRS tend to fall back on its existing playbook when situations like this arise, relying on technical attacks, extreme valuation positions, and broad assignations of blame? Could following this pattern with art donations cause problems for the IRS? Many readers of this article likely responded affirmatively to those four questions, but will the IRS come to the same conclusions? ■

[40]REG-106134-22; prop. reg. section 1.6011-9(e)(3) and (f).

[41]REG-106134-22, Section V, at 27.

[42]*Id.* at Section IV, 25-26.

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